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No. 426

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

ADAM, MELDRUM & ANDERSON CO., INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Adam, Meldrum & Anderson Co., Inc., prays that a writ of certiorari issue to review the judgment entered in this case on July 29, 1954, by the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of The Tax Court of the United States, entered March 26, 1953, is reported in 19 T.C. 1130, and is printed as Appendix D hereto, *infra*, page 32. The

opinion of the United States Court of Appeals for the Second Circuit has not yet been printed in the official reports but is printed as Appendix B hereto, *infra*, page 25.

JURISDICTION

The opinion and judgment of the United States Court of Appeals for the Second Circuit were entered on July 29, 1954, Appendix B and C, *infra*, pages 25, 30. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

1. Where, after the stock owned by petitioner in a subsidiary Bank had been cancelled and declared worthless by the Superintendent of Banking, the petitioner's liability to pay an assessment on such Bank stock became fixed as to liability and amount by a settlement and was thereafter paid, should such payment[1] be capitalized by being added to the basis of the Bank stock in the hands of the petitioner and then treated as a capital loss under Section 23(g) of the Code[2] or rather should it be allowed as a deductible loss under Section 23(f) of the Code.

2. Whether the construction given by the lower Court to Section 23(g)(4) of the Code is in accord with the legislative intent and purpose of Congress in enacting that section.

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[1] This question is phrased in terms of the payment of the Bank stock assessment in the sum of $137,187.35. However, as both the Tax Court and the Circuit Court of Appeals for the Second Circuit recognized, the disposition of that item should and did control the disposition of the other issues, namely, the certificates surrendered by the petitioner itself under the Plan in the sum of $2,767.47 and the item with respect to attorneys' fees aggregating $15,284.78. The latter items are, therefore, implicit in Question 1 and are included in the Petition for Certiorari.

[2] References to the Code throughout this Petition relate to the Internal Revenue Code of 1939, as amended.

STATUTES AND REGULATIONS INVOLVED

The applicable portions of the pertinent statutes and regulations involved are set forth in Appendix A, *infra*, p. 18.

STATEMENT

The facts, which are not in dispute, are briefly as follows:

The petitioner kept its books and accounts and filed its tax returns on the accrual basis, using a fiscal year ending each January 31. Petitioner, a New York corporation, is engaged in the department store business in Buffalo, New York. Since 1923 it has owned and operated a Bank situated on the mezzanine floor of its store premises for the mutual convenience and advantage of itself and its customers. In 1930 and 1931, the Bank fell into financial difficulties; and two stock assessments, together with a transfer of securities by the petitioner to it and other pledges by its directors, proved inadequate to support it. In May, 1953, the Superintendent of the Banking Department of the State of New York took possession of the Bank under New York Banking Law, § 606(1)(c, e). On the same day, on application of the Bank, he surrendered the assets and authorized it to resume business pursuant to New York Banking Law § 609, blocking 40 percent of its demand deposits and causing the Bank to issue Certificates of Withheld Deposits thereon to its depositors. In lieu of an assessment on the shareholders on account of their statutory double liability under New York Banking Law § 113-a, the Superintendent permitted the Bank to accept certain promissory notes and other security.

In 1940 the certificates had not been paid and the Bank sued the petitioner on a claim arising out of its statutory liability. Judgment was rendered for the Bank in 1942 and an appeal was taken by the petitioner. While the appeal was pending, a Plan was approved under New York Banking Law § 609(8) whereby the petitioner gave the Bank, in compromise of the pending litigation, $137,187.35

and certificates aggregating $2,767.47, which it had acquired by purchase; the Bank stock, having become worthless, was cancelled, new stock was issued to the certificate holders at the rate of $1 par for each $2 of unpaid principal claim; and the new stock was immediately assigned to the petitioner in exchange for merchandise certificates issued by it worth $2 for each $1 par value of stock.

Question 1: The Plan referred to above became effective upon April 19, 1943, the date upon which the Bank Superintendent of New York State filed a certificate in the form required by law in the office of the County Clerk, Erie County, New York. On that date under the Plan, the petitioner incurred liabilities to (1) pay $137,187.35 in settlement of the litigation, (2) surrender certificates it owned aggregating $2,767.47 and (3) pay various attorneys' fees incident to the litigation and the adoption of the Plan aggregating $16,534.78. These payments and the surrender were thereafter made. *Prior* to April 19, 1943, however, and not later than April 17, 1943, the petitioner's shares of old Bank stock "were cancelled and thereupon became null and void for all purposes and rights of the holders ceased."[3]

Before the Tax Court, with reference to the fiscal year ended January 31, 1944, the petitioner claimed full deductions for the $137,187.35, the $2,767.47, and the attorneys' fees aggregating $16,534.78.

The Tax Court held that the petitioner was properly entitled to deduct in full the $137,187.35 and the $2,767.47. In so holding the Tax Court first determined that these payments were "in the nature of or in lieu of" a bank stock assessment. Nevertheless, it authorized the deduction of these amounts because at the time of accrual and payment the "petitioner's stockholdings in the Bank had then ceased to exist." The Tax Court also allowed an ordinary deduction of $15,284.78 of the attorneys' fees and

[3] See Tax Court Opinion, Appendix D, p. 42.

required the capitalization of the balance thereof—$1,250.00—with reference to the acquisition of new Bank stock.

Upon appeal by the Commissioner, the Circuit Court of Appeals reversed and remanded, ruling that in spite of the fact that the payment and accrual of the various items (allowed as deductions by the Tax Court) had been made at a time *after* the old Bank shares had been declared void, had become worthless and had been cancelled, these items should, nevertheless, be capitalized and added to the cost basis of old Bank shares. A capital loss resulted.

It is the petitioner's contention that the deductions allowed by the Tax Court of the United States were correct, contrary to the holding of the Second Circuit Court of Appeals, and that these items need not be capitalized.

Question 2: This question relates to the contruction placed by the lower Court upon Section 23(g)(4) of the Code. Under the terms of that section the petitioner sought to justify the deduction in full of its cost basis of the old Bank shares ($205,700.00). Or, if it were held that the items referred to in Question 1 should be capitalized with reference to the old Bank shares, then the aggregate ($360,939.60)[4] of those items as capitalized plus the cost of the old Bank shares would be deductible in full. The petitioner contended in the Tax Court that, inasmuch as it was the sole stockholder of the Bank, the Bank was an "affiliated" corporation and that the loss arising from the worthlessness of the old Bank stock due to cancellation justified an ordinary deduction in full rather than a capital loss; because the Bank was an "operating" bank, the purpose and intent of Congress in enacting Section 23 (g)(4) (as indicated by the legislative history) justified the deduction sought even though more than 90 per cent of the Bank's gross income was in the form of interest.

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[4] This aggregate includes the following: $137,187.35, $2,767.47, $15,284.78 and $205,700.00. The petitioner concedes that $1,250.00 of attorneys' fees should be capitalized with reference to the new Bank shares (as found by the Tax Court and the Circuit Court); this reduces the attorneys' fees in issue from $16,543.78 to $15,284.78.

The Tax Court, holding that the language of Section 23(g)(4) was unambiguous, refused to consider the legislative history and ruled against the petitioner on this issue.

After considering the legislative history, the Circuit Court of Appeals sustained the Tax Court on this issue, ruling that the loss was a capital one and limited by the provisions of Sections 23(g)(2) and 117 of the Code.

The petitioner contends that the legislative history of Section 23(g)(4) discloses the Congressional intent to be that "operating banks" were not intended to be excluded from the terms of Section 23(g)(4).

REASONS FOR GRANTING THE WRIT

Question 1

A. The opinion of the lower Court has a significance far beyond the scope of the narrow question presented to it. The rationale underlying that Court's holding conflicts broadly with holdings in many other analogous types of situations affected by the tax statutes. The holding below contains implictly the requirement that an expenditure made (accrued and paid) by a taxpayer referable to a capital asset must be capitalized by being added to the basis of the capital asset *even though prior to the time of such payment or accrual the capital asset itself had ceased to exist and had become valueless.* The lower Court has ignored the practical dilemma that under such circumstances there is nothing to which such an expenditure can be appended under the philosophy of tax accounting. A brick cannot be added to a pyramid if the pyramid is non-existent. The specific problem presented to and considered by the Circuit Court is somewhat narrow;[5] how-

[5] The specific problem considered by the lower Court was, should the payment of a bank stock assessment (representing the double liability imposed upon bank stockholders under the New York statutes) be capitalized by being added to the cost basis of the old bank stock which had, prior to the accrual or payment of the bank stock assessment, been declared to be worthless and cancelled by

ever, the impact of the Court's *reasoning* would apply in many other types of tax transactions where it would be in fundamental conflict.

Conceptually, a comparable problem arises wherever a so-called "capital expenditure" has been made and (1) the capital asset itself does not finally come into existence or (2) the capital asset has already ceased to exist. In such situations the courts generally have recognized the practicalities involved and have, contrary to the thesis of the lower Court, allowed such expenditures as losses, debts or expenses. There are, however, some narrow cases in which the courts have, like the lower Court, disregarded the realities and have required capitalization. The result is confusion of concept and result.

Where research expenses are incurred with reference to the development of a particular capital asset and they result in a failure to bring into existence the asset in question, a similar problem arises. In such circumstances should the costs for research and development be capitalized or deducted as losses? In *Dresser Manufacturing Co.*, (1939) 40 B.T.A. 341 (A),. such expenditures which had been capitalized over a three-year period were held to be deductible by the taxpayer in full as a loss even though the expenditures were referred to as capital expenditures. In its opinion the Tax Court adverts to the rule that if experimentation results in a machine or contrivance which is practical and workable, a capital asset is acquired and expenditures made in connection therewith should be capitalized. It points out, however, that in contrast, where an unsuccessful attempt is made to develop a machine

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the appropriate state administrative official. In the period of the depression (1929-1933) many states enacted legislation imposing a double liability upon bank stockholders for the protection of bank depositors. Today all but two states have repealed such statutes. In a similar fashion, the former double liability of stockholders in Federal banks has likewise been repealed. See Title 12 U.S.C. Sec. 64a. The protection intended by these statutes has been rendered unnecessary by the enactment of Federal statutes insuring bank deposits.

which did not "result in the acquisition, development or improvement of a capital asset having a useful life beyond the taxable year in which the outlay was made" such expenditures were deductible in the year expended. See also *Homer L. Strong,* (1928) 14 B.T.A. 902.

Where the debt of a trust was guaranteed by a remainderman and the trust thereafter lost all of its assets through foreclosure, the remainderman made payment in satisfaction of his liability on the guarantee. It was held that the payment constituted a loss deductible by the remainderman under Code Section 23(e)(2) in spite of the fact that the giving of the personal guarantee enabled the trust to borrow funds which did enhance the remainderman's potential beneficial interest in the trust's corpus. See *J. B. Book, Jr.,* Docket No. 15314, T. C. Memo Op., Entered January 31, 1949.

Another broad field in which the distinction urged by the petitioner is recognized to be of vital significance is the field involving the tax treatment of attorneys' fees incurred in litigation. Generally speaking, if the litigation is successful and results in the acquisition of a capital asset the attorneys' fees must be capitalized and added to the cost of the asset. In contrast, if the suit is unsuccessful and no asset is acquired, the expenditures for attorneys' fees may constitute a loss or business expense. See *S. Cupples Scudder,* (1931) 22 B.T.A. 1294.

An analogous situation arises where tenants under a lease make payments to third parties for the benefit of the landlord. Where such payments enhance the value of the leasehold the tenant must capitalize such items and recover them over the remaining term of the lease. But where such payments have no lasting effect or do not increase the value of an asset, the tenant may deduct them as additional rent. See Regulations 111, Section 29.23(a)-10.

Again, where a tenant under a lease pays a bonus to the landlord for the privilege of terminating the lease the tenant may deduct in full such bonus as an expense, as he

has nothing of value left after termination. *Cassatt* v. *Commissioner,* (CCA-3, 1943) 137 F. (2d) 745. In contrast, where the landlord pays a bonus to the tenant for termination of a lease the landlord has obtained something of value and the amount paid must be capitalized and amortized over the term of the unexpired lease. *Harriet B. Borland et al.,* (1933) 27 B.T.A. 538.

While the petitioner has been unable to find a case of square conflict with the lower Court's holding on the same matter of law, there does appear to be a clear irreconcilable difference between the general principle or reasoning involved in the lower Court's decision and other Circuit decisions in analogous cases.

In *Messenger Corporation* v. *Smith,* (CCA-7, 1943) 136 F. (2d) 172, a question was presented as to whether a payment was a loss or a capital expenditure. The plaintiff had executed a contract with a broker under which the latter was to arrange for the conversion of the plaintiff's debentures into common stock and for such service agreed to pay and did pay $45,000.00 as compensation to the broker. The broker thereafter went bankrupt without having accomplished the services for which he had been hired. The taxpayer claimed the broker's fee as a loss. The Commissioner argued there that the loss was not deductible because if the contract had been executed a capital transaction would have taken place and mere failure to complete the security exchange did not render the transaction non-capital. The Seventh Circuit held, however, that the loss was a deductible one in full, pointing out that "the expenditures were for naught and no future capital event could ever occur in which there could be reflection and recognition of these expenditures" and as a result "there was no capital transaction to which the expenses could append."

In *M. A. Burns Manufacturing Co.* v. *Commissioner,* (CCA-9, 1932) 59 F. (2d) 504, a lumber company became insolvent and went into voluntary liquidation. A manu-

facturing company, whose president and sole stockholder likewise owned the stock of the lumber company, had assumed the lumber company's note to a bank for a consideration. The manufacturing company expected no return and did this solely "to help its own credit". Eventually the manufacturing company had to make payment on the note and claimed such amount as a loss deduction. The Commissioner contended that the payment was either a bad debt or a capital expenditure. Both the Tax Court and the Ninth Circuit allowed the loss deduction and the payment was not required to be capitalized.

The Commissioner himself has for some years taken as an official position that which the petitioner now urges. In I. T. 2843, XIV-1 Cum. Bull., 77 (1935) the Commissioner held that where a bank was in liquidation and assessment was made against stockholders under their statutory liability, the assessment was deductible in the year in which paid by a cash basis taxpayer and in the year of assessment in the case of an accrual basis taxpayer unless such liability was denied. In the latter event the amount accrued when the liability was finally determined or admitted. I. T. 3351, 1940-1 Cum. Bull., 87, holds that cash basis taxpayers paying a bank stock assessment on worthless bank stock are entitled to deduct such payments as losses under Section 23(e) (deductions in full) rather than under Sections 23(g)(1) and (2) (capital losses).

The Commissioner in various litigation has frequently taken the same position as the petitioner here. As recently as November 2, 1953 the Commissioner filed a brief in the Tax Court of the United States in *Estate of Mary B. Booth,* Docket No. 37085. The issue in that case relates to the nature of a refund of a bank stock assessment and the question is, is the refund ordinary income or a return of capital. This issue, in turn, must be resolved by determining whether the original payment of the assessment should have been capitalized or was a deductible loss. The government's brief in the *Booth* case cites the favorable Tax

Court opinion in this proceeding below and makes the very point the petitioner here contends for, namely that a different result should be reached in cases where bank stock assessments are paid on worthless bank stock than in cases where such a payment is made on valuable bank stock. See also Commissioner's argument in *Estate of Fred T. Murphy,* (1954) 22 T. C. —, No. 34.

Thus, not only are the administrative rulings of the Commissioner in square conflict with the Court below but, in addition, the Commissioner still takes a position opposed to that holding in bank stock assessment cases.

In contrast with the foregoing, where a debt of a wholly-owned subsidiary company becomes worthless due to insolvency and is thereafter cancelled by the parent-creditor it has been held that the amount so cancelled should be added to the cost of the stock in the subsidiary as a capital contribution. See *Lidgerwood Manufacturing Company,* 22 T. C. No. 141, Entered August 31, 1954. This is in conflict in principle with the Commissioner's own rulings, for example O. D. 297, 1919 Cum. Bull., 126, and with this Court's holding in *Spring City Foundry Co.* v. *Commissioner,* (1934) 272 U.S. 182. In the *Lidgerwood* case, the Tax Court's refusal to observe the very distinction here mentioned results in confusion. There the subsidiary's debt and its stock had both become worthless *before* the debt was cancelled.

Without further laboring the point, it seems obvious that the problem here involved can and does arise in such various other situations as development of patents, acquisition of licenses, obsolescence, condemnation proceedings, confiscation proceedings, and in connection with payments on mortgages. No attempt is made to discuss all possibilities. In all of these situations as well as others, problems inevitably will arise as to the proper tax basis and the consequent determination of gain or loss upon sale or exchange or loss due to other factors. The petitioner concludes, therefore, that the rationalization under-

lying the lower Court's holding in this case has an extremely broad significance running through a broad field of taxation. Moreover, the court decisions on these related problems are in some cases irreconcilable and in conflict in principle. A fair administration of the tax laws suggests the need for uniformity throughout.

B. The opinion of the Circuit Court of Appeals below is, in principle, in irreconcilable conflict with its own earlier decisions.

In *Champlain Coach Lines, Inc.* v. *Commissioner*, (CCA-2, 1943) 138 F. (2d) 904, a corporate taxpayer organized a subsidiary for the purpose of operating an intra-state bus route in New York state. The New York Public Service Commission denied the subsidiary's application for a certificate of convenience and necessity in 1937 and again in 1938. Between 1935 and 1938 the taxpayer had incurred expenses in connection with processing these applications for certificate. The issue involved whether the taxpayer could deduct such expenditures as losses. Judge Augustus Hand speaking for the Second Circuit reversed the Tax Court and remanded, holding that the expenditures were not capital investments but were losses incurred by the taxpayer. His opinion noted that:

> "The very objects for which the payments were made were completely frustrated. Inasmuch as the expenditures could under no circumstances be recovered by the taxpayer, its claim for a deduction seems unanswerable."

Moreover, in this case Judge Hand considered and distinguished the case of *Interstate Transit Lines* v. *Commissioner*, (CCA-8, 1942) 130 F. (2d) 136, aff'd 319 U. S. 590, which was specifically cited and relied on by the same Court (with a different panel sitting) in the holding below.

Two other cases in the Second Circuit indicate by silence that Court's agreement in principle with the rationale of *Champlain Coach Lines, Inc.* v. *Commissioner, supra*, and

are, therefore, likewise irreconcilable with that Court's holding in this proceeding. In *Jamieson Associates, Inc.*, (1938) 37 B.T.A. 92, reversed by the Second Circuit in 1939 under the name of *Seaside Improvement Company* v. *Commissioner*, (CCA-2, 1939) 105 F. (2d) 990, payment of a bank stock assessment was involved. The Tax Court held the payment deductible in full as the bank stock was worthless before the payment of the assessment. While that specific issue was not raised on appeal, the Second Circuit did have the case before it at the time it ruled. A similar situation exists in the case of *Marjorie Fleming Lloyd-Smith*, (1939) 40 B.T.A. 214. That case involved an expenditure under a bond guarantee where at the time of the expenditure the stock of the guaranteed company had become worthless. The Tax Court allowed the deduction as a loss. On appeal this specific issue was not raised before the Second Circuit. Nevertheless, the Circuit Court affirmed the Tax Court without discussion of this point. See *Marjorie Fleming Lloyd-Smith* v. *Commissioner*, (CCA-2, 1941) 116 F. (2d) 642, cert. den.

C. The Second Circuit Court of Appeals in its opinion below erroneously misinterpreted and misapplied the opinion of this Court in *Arrowsmith, Exec.* v. *Commissioner*, (1952) 344 U. S. 6.

The Second Circuit below, having found with the Tax Court that the old Bank stock "was cancelled before the liability was paid", then proceeded to state:

> "The payment was made on account of the statutory bank stock liability, which continues until satisfied, whether or not the stock itself be cancelled. Nor can the taxpayer's delay in meeting its existing obligation change statutory liability into something else. *Arrowsmith* v. *C. I. R.*, 344 U. S. 6."

The petitioner submits that this is an improper extension and application of the *Arrowsmith* doctrine.

Arrowsmith involved a transferee who had claimed an ordinary deduction in full upon the payment of a trans-

feree liability when several years prior the transferee had received the assets of a dissolved corporation in a liquidating distribution at capital gains rates. This Court held that the payment of transferee taxes was a capital loss rather than an ordinary loss, the distinction turning upon the nature of the payment of tax itself. The reasoning was that the liquidation of the dissolved corporation was a continuing capital transaction which was not completed until the liability for taxes was finally determined. Therefore, the nature of the payment of transferee taxes was a capital one. This was ascertained by looking back to the capital transaction which occurred at the time of dissolution. The result apparently turned to a considerable extent upon equitable considerations. Accepting the results and the doctrine of the *Arrowsmith* case, the citation of that case by the Court below extends that doctrine far beyond the scope of broad equity into the field of technical statutory construction. There is no pressure of equity in this case below such as existed in *Arrowsmith*.[6] There was

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[6] Note pertinent comment on Circuit Court's Opinion in *The Tax Barometer*, Vol. 11, No. 36, August 7, 1954, as follows:

> "Comment.—The Court's conclusion as to the nature of the taxpayer's payment on the previously worthless stock seems deceptively 'pat'. Actually, the Arrowsmith case is a misleading precedent. In that case, the taxpayer was repaying an amount previously received as income and since the income has been taxed in a prior year as capital gain, it was only equitable to treat the repayment as a capital loss.
>
> "No such equity arises here. The question is one of statutory application. A loss due to worthlessness of stock is treated as a capital loss under the statute. The question is whether a loss due to an assessment paid after stock has become worthless is a loss due to the worthlessness of the stock within the meaning of the statute. Thirteen judges of the Tax Court thought not. And it may well be distinguished as a loss due to the former ownership of the stock rather than a loss due to its worthlessness. It is a delicately balanced legal question, and the Second Circuit's recourse to the blunt analogy of the Arrowsmith case without even posing the question of statutory application hardly shapes up as a convincing demonstration."

no previous capital transaction, nor had the petitioner received anything from the Bank.

The real question presented to the Court below, which was never expressly adverted to, involves the construction of Section 23(g)(2) of the Code and a determination of whether under that section a payment of a bank stock assessment *after* such stock had become worthless and nonexistent constituted a loss due to the worthlessness of the stock within the language of the cited section. The petitioner submits that the real problem was one of statutory construction and not equity. Citation of *Arrowsmith* was therefore inapposite. However, precise construction of the statute is still imperative and unresolved.

Question 2

A. Section 23(g)(4) of the Code provides an exception to the general rule that worthless stock results in a capital loss under Section 117 of the Code. The exception applies where a taxpayer owns stock in an affiliated corporation which becomes worthless. In such event if the degree of affiliation embraces ownership by the taxpayer of at least 95 percent of each class of stock of the subsidiary and if the subsidiary derives more than 90 percent of its income from certain specified sources, then the stock of the subsidiary shall be deemed not to be a capital asset. The petitioner contends that it comes within the purview of Section 23(g)(4). If controlling, that section will permit a deduction in full at least to the extent of the cost of the old Bank shares, $205,700.00, or alternatively, if the amounts referred to under Question 1 are to be capitalized, then the amount of $360,939.60 will be allowable.

There is no dispute but that the petitioner was the owner of more than 95 per cent of the old Bank shares, nor is it disputed that those shares were cancelled and became worthless during the taxable year. The only question relates to the subsidiary's gross income.

The section in question provides that if more than 90 percent of the aggregate gross income of the subsidiary is from sources such as royalties, rents, dividends, interest, annuities, or gains from sale of stock, then Section 23(g)(4) will not apply.

The subsidiary Bank in this case derived more than 90 percent of its income from interest. However, the legislative history indicates the clear intent of Congress not to bar an *operating bank* from Section 23(g)(4)(B). The interdict of the section was designed to apply against non-operating or purely holding type subsidiaries. This is indicated not only by the legislative history but by the parenthetical use of the word "operating" in the section referred to.

The Congressional intent with reference to the section in question is made clear by the remarks of Senator Davis of Pennsylvania at the time he offered an amendment to Section 23(g)(4)(B) which added the language now contained in the parentheses in that section.[7] Senator Davis' language leaves no doubt but that an *operating* company was not intended by Congress to be excluded from the provisions of Section 23(g)(4)(B).[8] It seems apparent that the Congress was attempting to exclude personal holding companies from the benefits of the section. Yet banks as such are not within the definition of personal holding companies. There is, therefore, nothing in the intent of Congress to bar an operating bank and conversely, that intent appears to have been designed to apply to all operating concerns, including banks.

The Tax Court in considering this question refused to look to the legislative history to determine the meaning of Section 23(g)(4). That Court held that resort to legislative history was without propriety as there was no

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[7]—6 Cong. Rec. 121 (78th Cong., 1st Sess., January 12, 1944). See also legislative history of Sec. 152(2) and S. R. 648 of Finance Comm., 76th Cong., 1st Sess., p. 9.

[8] Compare Sec. 23(k)(5)(B) and its legislative history.

ambiguity. However, even the absence of an ambiguity does not prevent resort to legislative history to determine the proper meaning of a tax provision.[9] The Court below, unlike the Tax Court, did consider the legislative history but held, however, that it could not set aside the Tax Court's ruling on this issue. The Circuit Court concluded that the legislative history stressed "the limits, rather than the extent of the section", and hence did not control. The petitioner respectfully submits that the lower Court has erroneously misconstrued the intent of Congress in enacting Section 23(g)(4) and, by refusing to carry out that purpose, has vitiated such intent.

CONCLUSION

This Petition for Writ of Certiorari should be granted.

Respectfully submitted,

FRED R. TANSILL,
Counsel for Petitioner,
824 Connecticut Avenue, N. W.,
Washington 6, D. C.

Of Counsel:
EUGENE MEACHAM.

October, 1954

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[9] *Kelm* v. *Chicago, St. Paul, Minneapolis & Omaha Rwy. Co.*, (CCA-8, 1953) 206 F. (2d) 831.

APPENDIX A

Statute and Regulations Involved

"INTERNAL REVENUE CODE:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES.—

"(1) TRADE OR BUSINESS EXPENSES.—

"(A) IN GENERAL.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

* * * *

"(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or * * *"

* * * *

"(f) LOSSES BY CORPORATIONS.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

"(g) CAPITAL LOSSES.—

"(1) LIMITATION.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

"(2) SECURITIES BECOMING WORTHLESS.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

"(3) DEFINITION OF SECURITIES.—As used in this paragraph (2) of this subsection the term 'securities' means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

"(4) STOCK IN AFFILIATED CORPORATION.—For the purposes of paragraph (2) stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

"(A) at least 95 per centum of each class of its stock is owned directly by the taxpayer; and

"(B) more than 90 per centum of the aggregate of its gross income for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

"(C) the taxpayer is a domestic corporation."

(As amended by the 1942 and 1943 Acts.)

* * * *

"(k) BAD DEBTS.—

* * * *

"(5) SECURITIES OF AFFILIATED CORPORATIONS.—Bonds, debentures, notes or certificates, or other evidences of indebtedness issued with interest coupons or in registered form by any corporation affiliated with

the taxpayer shall not be deemed capital assets for the purposes of paragraph (2) and paragraph (1) shall apply with respect to such debt except that no such deduction shall be allowed under such paragraph with respect to any such debt which is recoverable only in part. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

* * * *

"(B) more than 90 per centum of the aggregate of its gross income for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

* * * *"

"SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the corporation dividend paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death."

* * * *

"SEC. 152. PAN-AMERICAN TRADE CORPORATIONS.

"If a domestic corporation engaged in the active conduct of a trade or business within the United States (hereinafter referred to as the 'parent corporation') owns directly 100 per centum of the capital stock of one or more domestic corporations each of which is engaged solely in the active conduct of a trade or business in Central or South America (hereinafter referred to as a Pan-American trade corporation), such corporations (including the 'parent corporation') shall be deemed to be an affiliated group of corporations within the meaning of section 141 of this chapter, provided that the following conditions are satisfied:

* * * *

"(2) At least 90 per centum of the gross income for the taxable year of each of the Pan-American trade corporations is derived from sources other than royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stock or securities; and

* * * *"

(This provision was added by Sec. 225 of the Revenue Act of 1939. It was effective for the taxable years beginning after December 31, 1939. Sec. 159(b) of the Revenue Act of 1942 provided that this provision should not apply with respect to the taxable years beginning after December 31, 1941.)

* * * *

"SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY

* * * *

"(b) EXCEPTIONS.—The term 'personal holding company' does not include—

* * * *

"(2) A bank as defined in section 104.

* * * *"

REGULATIONS

REGULATIONS 111

"DEDUCTIONS—LOSSES BY INDIVIDUALS

"*Sec. 29.23(e)-1 Losses by individuals*

• • • •

"In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b). For special provisions with respect to war losses, see section 127."

• • • •

"*Sec. 29.23(e)-4. Shrinkage in value of stocks.*—A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis as determined and adjusted under section 113 and sections 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive, is deductible by the owner for the taxable year in which the stock became worthless, provided a satisfactory showing is made of its worthlessness. Federal or State authorities incident to the regulation of banks and certain other corporations may require that stock be charged off as worthless or written down to a nominal value. If, in any such case, the basis of the requirement is the worthlessness of the stock, such charging off or writing down will, for income tax purposes, be considered prima facie evidence of worthlessness; but if the charging off or writing down is due to market fluctuations, or if no reasonable attempt has been made to determine worthlessness, no deduction for income tax purposes of the amount so charged off or written

down can be allowed. For dealers in securities, see section 29.22(c)-5. For limitations on deductions for losses from sales or exchanges of capital assets generally, including stocks and bonds, see section 117.

• • • •

"DEDUCTIONS—LOSSES BY CORPORATIONS

"*Sec. 29.23(f)-1. Losses by corporations.*—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible in so far as not prohibited or limited by sections 23(g), 23(h), 24(b), 112, 117, 118, and 251. The provisions of sections 29.23(e)-1 to 29.23(e)-5, inclusive, and section 29.23(i)-1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations. For special provisions with respect to war losses, see section 127."

• • • •

"ITEMS NOT DEDUCTIBLE

• • • •

"*Sec. 29.24-2. Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23(1).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See

section 29.22(a)-16.) An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible, but, subject to the provisions of the Internal Revenue Code, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary."

APPENDIX B

Opinion of the Second Circuit Court

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 263—October Term, 1953.

(Argued May 5, 1954 Decided July 29, 1954)

Docket No. 22950

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

v.

ADAM, MELDRUM & ANDERSON CO., INC., *Respondent.*

Before:

CLARK, FRANK and MEDINA, *Circuit Judges.*

Petition to review an order of the Tax Court of the United States, C. Rogers Arundell, Judge.

The Commissioner determined a deficiency in excess profits tax paid by respondent, Adam, Meldrum & Anderson Co., Inc., for the year 1944. The Tax Court redetermined the deficiency, finding against the Commissioner on the points here in issue, 19 T.C. 1130, and the Commissioner petitioned for review. Reversed and remanded.

S. DEE HANSON, Sp. Asst. to the Atty. Gen., Washington, D. C. (H. Brian Holland, Asst. Atty. Gen., and Ellis N. Slack and Lee A. Jackson, Sp. Assts. to the Atty. Gen., Washington, D. C., on the brief), for petitioner.

FRED R. TANSILL, Washington, D. C. (John F. Connelly, Buffalo, N. Y., and Eugene Meacham, Washington, D. C., on the brief), for respondent.

CLARK, Circuit Judge:

This petition involves the proper tax treatment of certain transactions undertaken by respondent, Adam, Meldrum & Anderson Co., Inc., taxpayer, and arising out of the financial difficulties of its subsidiary, Adam, Meldrum & Anderson State Bank, and the liability imposed by statute on holders of bank stock. The issues concern the taxpayer's excess profits tax for the year 1944. The facts are fully stated in the decision of the Tax Court, reported in 19 T.C. 1130.

Taxpayer, a New York corporation, is engaged in the department store business in Buffalo, New York. Since 1923 it has owned and operated a bank situated on the mezzanine floor of its store premises for the mutual convenience and advantage of itself and its customers. In 1930 and 1931, the Bank fell into financial difficulties; and two stock assessments, together with a transfer of securities by the taxpayer to it and other pledges by its directors, proved inadequate to support it. In May, 1933, the Superintendent of the Banking Department of the State of New York took possession of it under N. Y. Banking Law, §606 (1)(c, e). On the same day, on application of the Bank, he surrendered the assets and authorized it to resume business pursuant to N. Y. Banking Law § 609, blocking 40 per cent of its demand deposits and issuing Certificates of Withheld Deposits. In lieu of an assessment on the shareholders on account of their statutory double liability under N. Y. Banking Law §113-a, the Superintendent permitted the Bank to accept certain promissory notes and other security.

In 1940 the certificates had not been paid, and the Bank sued the taxpayer on a claim arising out of its statutory liability. Judgment was rendered for the Bank in 1942, and an appeal was taken. While the appeal was pending, a plan was approved under N. Y. Banking Law §609(8) whereby the taxpayer gave the Bank, in compromise of the pending litigation, $137,187.35 and certificates aggregating $2,767.47, which it had acquired by purchase; the bank stock, having become worthless, was cancelled, new stock was issued to the certificate holders at the rate of

$1 par for each $2 of unpaid principal claim; and the new stock was immediately assigned to the taxpayer in exchange for merchandise certificates worth $2 for each $1 par value of stock.

The settlement and consummation of the plan took place during the taxable year 1944. Taxpayer sought to deduct the sums paid in settlement of the litigation and certain related legal expenses as ordinary and necessary business expenses, or as business losses incurred in that year. The Commissioner takes the view that, since the plan left the taxpayer's ownership unimpaired, the transaction involved no more than a reorganization or an additional contribution of capital, and that no loss occurred; or alternatively that any loss was one on stock under I.R.C. §23(g)(2) and hence limited by I.R.C. §117 in substance to offset capital gains. The Tax Court found for taxpayer, three judges dissenting; and the Commissioner petitioned for review.

At the outset it is clear that the taxpayer's original investment was wiped out by the cancellation of the old stock. The Superintendent in the course of his official duties and on sufficient evidence declared the stock to be worthless at a time when the Bank's liabilities far exceeded its assets. True, the cancellation of shares was undertaken under the same plan whereby the taxpayer bought out the interest of the certificate holders; but that does not alter the situation. N. Y. Banking Law §609(8)(a) authorizes such a plan only when the bank's liabilities (including the unpaid amount of certificates) exceeds its assets. Hence a prerequisite is the worthlessness of the stock. To treat the events under the plan as a reorganization or capital contribution, as urged by the Commissioner, we must view the certificate holders as ordinary creditors who have at last been paid. But N. Y. Banking Law §609(5, 6) places the certificate holders substantially in the shoes of stockholders, and when the original stock is found worthless and cancelled they must hold whatever equity remains. Thus the issuance to them of new stock was no more than an appropriate recognition of their interest. And in very real sense the assignment of their interest to the taxpayer in return for merchandise certificates was a sale for value.

In short, the taxpayer's investment having been wiped out it repurchased the Bank from its new owners. Accordingly the cancellation of stock established a loss within the tax year 1944.

As for the nature of the sums paid in settlement of the litigation, however, we think (with the dissenting judges below) that the Commissioner's alternative position has merit. It is settled that an assessment of the statutory double liability imposed on the holders of bank stock is not a loss, but must be treated as an additional cost of the stock to the stockholder. *First Nat. Bank in Wichita* v. *C.I.R.*, 10 Cir., 46 F. 2d 283; *Porter Property Trustees, Ltd.*, 42 B.T.A. 681, affirmed without discussion of this point, *Porter* v. *C.I.R.*, 9 Cir., 130 F. 2d 276; *Tuttle* v. *United States*, 122 Ct. Cl. 1, 101 F. Supp. 532, 535; see *Interstate Transit Lines* v. *C.I.R.*, 8 Cir., 130 F. 2d 136, affirmed 319 U.S. 590; U. S. Treas. Reg. 111, §29.24-2. The Tax Court recognized this principle; but finding that the old stock was cancelled before the liability was paid, it held that in paying the sum, "which was undoubtedly in the nature of or in lieu of an assessment, it suffered a complete out-of-pocket loss for [taxpayer's] stockholdings in the bank had then ceased to exist." While this, as a statement of fact, is impeccable, we cannot follow the Tax Court to its conclusion that an ordinary deductible business loss resulted. The payment was made on account of the statutory bank stock liability, which continues until satisfied, whether or not the stock itself be cancelled. Nor can the taxpayer's delay in meeting its existing obligation change statutory liability into something else. *Arrowsmith* v. *C.I.R.*, 344 U.S. 6. This expense, *viz.*, the $137,187.35 paid the Bank, plus the $2,767.47 paid for the certificates transferred to the Bank, must be added to the tax base of the old stock, and charged as a capital loss under I.R.C. §§23(g)(2) and 117 as of the time of the cancellation. The same holds true as to the sum of $11,180.50 paid to counsel for the Bank as part of the settlement, and the sum of $4,104.28 paid to the taxpayer's counsel for services in the litigation. The $1,250 paid to counsel for the taxpayer in connection with the acquisition of the new shares, how-

ever, is a part of the cost of these shares and hence is not presently in issue. *Brand* v. *C.I.R.*, 6 Cir., 209 F. 2d 255; *Mills Estate* v. *C.I.R.*, 2 Cir. 206 F. 2d 244; *Safety Tube Corp.* v. *C.I.R.*, Cir., 168 F. 2d. 787.

Taxpayer seeks to avoid this result by relying on I.R.C. §23(g)(4), added by the Revenue Act of 1942. Its argument cannot, however, be sustained. That section provides that losses on the stock of an "affiliated" corporation may be fully deducted, without the limitation of I.R.C. §117. But it requires as a condition of this exception that more than 90 per cent of the affiliate's income be derived "from sources other than royalties, rents * * * dividends, interest * * * annuities, or gains from sales or exchanges of stocks and securities." Taxpayer concedes that "at first blush" the section is not applicable to this bank, whose income is derived from interest, but argues that this is an overliteral reading nullifying congressional intent. To support its position it cites legislative history[1] tending to show that the quoted provision sought to confine the relief accorded by the section to operating, as opposed to holding or investment, companies. But the particular references cited appear to stress the limits, rather than the extent, of the section, to satisfy the doubts of other legislators lest holding companies, too, be excepted. And the proposed alternative reading applying to "all operating companies" would open the door to insurance companies, finance companies, real estate operating companies, etc., without suggestion of any workable limitation. Congress has enunciated a clear and simple rule which, we agree with the Tax Court, is not to be set aside. Accordingly the loss is one on stock under I.R.C. §23(g)(2). The decision of the Tax Court must therefore be reversed and the proceeding remanded for a recomputation of the tax in accordance with the views herein set forth.

Reversed and remanded.

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[1] Sen. Rep. No. 648, 76th Cong., 1st Sess., Rep. of the Finance Committee, 9; 6 Cong. Rec. 121, 78th Cong., 1st Sess., Jan. 12, 1944, remarks of Sen. Davis.

APPENDIX C

Judgment of the Second Circuit Court

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 29th day of July, one thousand nine hundred and fifty-four.

Present:

HON. CHARLES E. CLARK,
HON. JEROME N. FRANK,
HON. HAROLD R. MEDINA,
Circuit Judges

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

ADAM, MELDRUM & ANDERSON, INC., *Respondent*.

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed and action remanded in accordance with the opinion of this Court.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

A. DANIEL FUSARO, *Clerk*.
By /s/ RALPH C. CURCIO,
Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

Commissioner of Internal Revenue

v.

Adam Meldrum & Anderson Inc.

(263)

JUDGMENT

United States Court of Appeals
Second Circuit
Filed Jul 29, 1954
A. Daniel Fusaro, Clerk

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APPENDIX D

Opinion of the Tax Court

19 T. C. No. 130

THE TAX COURT OF THE UNITED STATES

ADAM, MELDRUM & ANDERSON CO., INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 24599

Promulgated March 26, 1953.

1. The sum petitioner was obligated to pay because of its statutory liability as a stockholder in a New York state bank *held* deductible as an ordinary loss under section 23(f) where petitioner's obligation accrued at a time when the bank stock was worthless.

2. The basis to petitioner of bank stock found to be worthless held deductible as a capital loss and not deductible as an ordinary loss under section 23(g)(4) where more than 90 per cent of the aggregate of the bank's gross income for all taxable years has not been from sources other than interest.

3. Deductibility of legal fees determined.

Fred R. Tansill, Esq., Eugene Meacham, Esq., and *John F. Connelly, Esq.,* for the petitioner.

Michael Waris, Jr., Esq., for the respondent.

The respondent has determined a deficiency of $207,927.52 in the excess profits tax liability of the petitioner for the taxable year ended January 31, 1944, and the petitioner has filed a claim for refund of part of the excess profits taxes paid for that taxable year.

The petitioner assigns error to the respondent's determination that the sum of $139,952.84, which the petitioner seeks to deduct as an ordinary and necessary business expense or business loss incurred in the taxable year 1944,

represents an assessment and should be capitalized and, in addition, the petitioner assigns error to the determination that the expenditure of $16,534.78 in the taxable year 1944 for legal services which the petitioner seeks to deduct as an ordinary and necessary business expense or business loss should be capitalized.

Finally, the petitioner assigns as error the respondent's disallowance of a loss deduction for the cost of stock in the bank which the petitioner contends became worthless during the taxable year 1944.

This proceeding, together with the proceedings in Docket Nos. 25824 and 29141, were consolidated for hearing and opinion. The proceedings in Docket Nos. 25824 and 29141 have been disposed of by stipulations incorporated in decisions and orders entered on February 7, 1952.

Findings of Fact

The petitioner is a New York corporation organized in 1923 to engage in the department store business with its principal office and place of business in Buffalo, New York. It carried on a business formerly conducted by Adam, Meldrum & Anderson Company, a joint stock association, and other predecessors since 1867 at the same location.

The petitioner maintained its books and records and filed its Federal tax returns upon the accrual basis, and used a fiscal year ending January 31. The returns for the taxable year in question were filed with the collector of internal revenue for the 28th district of New York.

Adam, Meldrum & Anderson State Bank, hereinafter sometimes referred to as the Bank, was organized under the laws of the State of New York on May 8, 1923. On May 15, 1923, it acquired the assets of a banking company which had conducted a banking business at the same location since 1906. After May 15, 1923, the Bank conducted a general banking business under its charter.

On April 27, 1929 and thereafter, the authorized capital stock of the Bank consisted of 1,750 shares of common stock with a par value of $100 per share. The petitioner held 1,700 shares which had a cost basis to the petitioner of $205,700.

The remaining 50 shares were qualifying shares issued to directors of the Bank. Robert B. Adam, hereinafter referred to as Adam, held 10 of the qualifying shares.

The Bank has always been located on the mezzanine floor of petitioner's store. It was accessible only by means of the store stairways or a store elevator. There were no outside entrances to the Bank and customers of the Bank had to pass through the store in order to reach the Bank. During the taxable year in question, the Bank's hours of business exactly coincided with the store's hours of business. The Bank's telephone is an extension off the petitioner's switchboard.

During the taxable year, many of the depositors of the Bank were also customers of petitioner. Likewise, many of petitioner's customers were also depositors of the Bank. Petitioner had many more customers than the Bank had depositors. The Bank was organized by the store to accommodate the store's customers and to increase its business. Petitioner at all times has been interested in the well-being and continuance in business of the Bank. Petitioner was benefited by reason of Bank customers passing through the store.

Robert B. Adam, hereinafter referred to as Adam, was at all times material hereto and until his death on April 11, 1940, president of the Bank, president of petitioner, and a director of each. Until May 23, 1933, he was the owner of 5,001 shares of the common stock of petitioner, which constituted voting control. His wife was Lena S. Adam who died on August 1, 1940.

During the years 1930 and 1931, the Superintendent of the Banking Department of the State of New York, hereinafter referred to as the Superintendent, determined that the affairs of the Bank were in an infirm condition and that its capital was impaired. On December 31, 1930, he directed an assessment of $15 per share on the stockholders of the Bank, and the petitioner paid $25,500 as its share of the assessment. On June 30, 1931, he directed a second assessment of $6 per share and the petitioner paid $10,200 as its share. These two assessments totaling $35,700 constituted additional costs of the shares of Bank stock held by the petitioner.

As a further consequence of the financial condition of the Bank and at the instigation of the Superintendent, the petitioner transferred to the Bank, in November, 1931, a group of securities having a cost basis of $63,850 to the petitioner. In October and December, 1931, the directors of the Bank executed promissory notes payable to the Bank on demand in the total sum of $190,000. These notes were given as additional security for the depositors of the Bank and are sometimes referred to herein as "directors' guarantee notes". Adam's share of the $190,000 was $75,000 and his promise was binding on his representatives and assigns.

On February 13, 1932, Adam and his wife, for the further security of the Bank's depositors, pledged to the Bank a collection of books, hereinafter referred to as the Library, which had a value of approximately $400,000, and agreed that in case of a possible liquidation of the Bank the Library should be sold, if necessary, and the proceeds applied to the payment of the depositors with any balance remaining thereafter returned to them.

On March 5, 1932, an agreement was entered into whereby the petitioner transferred to Adam title to all of its 1,700 shares of common stock in the Bank and Adam assumed the petitioner's statutory liability as a shareholder of the Bank. To effect the transfer, the old certificates were surrendered and cancelled and in place thereof new certificates were issued to Adam.

Adam held these shares as nominee for the petitioner. The petitioner retained the beneficial interest and at all times until the consummation of the Plan referred to subsequently, the petitioner remained the real owner of the shares. It was agreed that upon demand of the petitioner, Adam would re-transfer the shares to the petitioner if the Superintendent indicated that the capital stock of the Bank had attained its par value. Adam never reconveyed the Bank stock to petitioner as provided for in the agreement.

On March 5, 1932, Adam and his wife also entered into an agreement pursuant to which Adam guaranteed to make good to the Bank's depositors any loss which might result

to them from the impairment of the Bank's capital to the amount of $500,000 which included Adam's assumed liability on the 1,700 shares. As security for the guarantee, Adam, together with his wife, pledged the Library. The previous guaranty agreement, pursuant to which the Library had been pledged, was expressly cancelled.

The agreements of March 5, 1932, arose from the following circumstances: The investments of the Bank had shrunk in value and the capital stock owned by the petitioner had become a potential liability. To preserve its integrity and to permit it to continue in business, the Bank was required by the Superintendent to secure or replace the amount of depletion in the value of its capital stock. The petitioner, as owner of 1,700 shares, was subject to the double liability imposed by the statutes of New York State upon the owners of stock of banking corporations. It would have been liable for assessments to pay depositors up to $170,000 ($100 per share) in the event of a forced liquidation of the Bank. However, the petitioner was unable to pay to the Bank an amount necessary to make the Bank's capital stock whole or to secure the deficiencies in its capital. Therefore, the petitioner entered into the agreement of March 5, 1932, with Adam, its president and controlling stockholder. The Superintendent was aware of and participated in these transactions and no attempt was made to deceive him.

From March 4 until March 15, 1933, all New York Banks were closed by proclamation of the Governor.

On May 29, 1933, the Superintendent took possession of the Bank and on the same day, upon application of the Bank, he surrendered the assets and authorized it to resume business. The surrender and authorization were on the condition that, in lieu of an assessment by the Superintendent upon the shareholders on account of their statutory liability as stockholders, the stockholders would execute promissory notes payable to the Bank's order on demand in the aggregate sum of $175,000 ($100 per share), the then aggregate amount of their liability. The notes were executed and included a note in the sum of $171,000 executed by Adam. One hundred and seventy thousand dollars of the $171,000 note executed by Adam related to

the 1,700 shares transferred by the petitioner to Adam as nominee and $1,000 related to the 10 shares owned by Adam. The notes were renewed in 1939.

Another condition was that title be obtained to the Library. On May 29, 1933, the Bank received a "bill of sale" that had been executed by Adam and his wife on May 20, 1933, conveying the Library to the Bank. In the conveyance, it was provided that upon sale of the Library by the Bank, the proceeds were to be applied: (1) to reimburse the Bank for the discharge of a prior lien on the Library; (2) to pay the liability of Adam as stockholder of the Bank; (3) to pay depositors and creditors of the Bank; (4) to restore the Bank's capital in full; (5) to pay the balance to Adam. In consideration of this transfer, the Bank cancelled the guarantee and pledge of March 5, 1932, and Adam's promissory note and guarantee in the sum of $75,000 given in 1931.

In fulfillment of another condition, the Bank, upon reopening on May 29, 1933, withheld 40 per cent ($783,927.71) of its depositors' funds and issued to them certificates of withheld deposits aggregating that amount. The Superintendent required the withholding of 40 per cent of Bank depositors' funds which he had determined were represented by "unsound assets". In accordance with certain administrative principles enunciated by the New York State Banking Board, the Bank was required to segregate sound from unsound assets, and write down the values of the unsound assets to a reduced figure, based on probable present, collectible values which, in the opinion of the Bank examiner, were sound values.

At the close of business on May 27, 1933 (a Saturday), the balance sheet of the Bank showed liabilities in excess of assets in the amount of $10,226.54. On that date the Superintendent directed that the value of the assets be reduced to what he determined to be their sound values. After this reduction on May 27, 1933, liabilities exceeded assets by $620,740.71 and resulted in a deficit of $445,740.71 after taking into account the capital stock in the sum of $175,000.

At the opening of business on May 29, 1933, the balance sheet showed surplus and undivided profits totaling $108,196.75. The elimination of the deficit and the creation of the surplus and undivided profits were accomplished by the Superintendent's direction to reduce deposits by 40 per cent and issue therefor certificates of withheld deposits. These certificates of withheld deposits were not shown as a liability on the balance sheet referred to above and there was segregated for their benefit that portion of the book value of the assets eliminated by direction of the Superintendent, plus the Library, the $175,000 in notes (referred to as "stock assessment notes") and the directors' guarantee notes in the amount of $115,000.

It was known and understood by the petitioner and Adam that when Adam took nominal title to the 1,700 shares of Bank stock owned by the petitioner he was subjecting himself, as record holder, to statutory liability for an assessment that might thereafter be imposed and, further, that he was willing to do so to benefit the petitioner. At a meeting on December 1, 1936, the petitioner's board of directors adopted a resolution in which the petitioner acknowledged its agreement and obligation to reimburse and indemnify Adam for expenditures or losses he might sustain by reason of the assumption of the statutory liability imposed on the petitioner as a Bank stockholder, the sale of the Library to the Bank, and the execution of the promissory note by Adam upon reopening of the Bank in 1933.

The New York State Banking Department had been continuously urging the directors of the Bank to take steps, on behalf of the holders of certificates of withheld deposits, to realize on the directors' "guarantee notes" and on the stockholders' notes. Notwithstanding such urging, no payments had been made at any time on the notes and no actions had been brought to enforce them. The directors had been unable to effect a sale of the Library. The death of Adam on April 11, 1940, brought matters to a head.

On June 18, 1940, the Bank as plaintiff filed an action in the Supreme Court of New York. The Bank was represented by special counsel appointed in May, 1940. The Bank asserted four causes of action and named several

defendants, including petitioner and the estates of Adam and his wife in the person of their administrators. Only the third cause of action is material to this proceeding.

In the third cause of action, the Bank named as defendants the petitioner and the estates of Adam and his wife. The Bank sought to recover from Adam's estate the sum of $171,000 (plus interest) which was the amount of the demand note executed by Adam at a time when he and other shareholders of the Bank were liable to an assessment in the sum of $100 per share. The Bank explained in its allegations forming the basis of the cause of action that the Superintendent, after having taken possession of the Bank, surrendered possession and permitted the Bank to resume business relying upon the $171,000 promissory note and other security.

Of the $171,000, $170,000 represented notes executed by Adam as record holder of the 1,700 shares owned by the petitioner, title to which had been taken by Adam as a convenience to the petitioner. The additional $1,000 related to 10 shares of stock owned by Adam. The Bank explained in the allegations forming the basis of the third cause of action that the petitioner agreed to reimburse Adam to the extent of all payments which he might make as a result of the transfer of title to the 1,700 shares.

The Bank also alleged in this cause of action that after applying the estimated, realizable value of the Library and the assets (other than Adam's promissory note) that were to be liquidated only for the benefit of holders of certificates of withheld deposits, approximately $299,132.42 would be left owing to depositors and would remain unpaid unless the Bank had the benefit of the "counter-bond or security" which Adam received from the petitioner. Accordingly, the Bank sought recovery of $170,000 from the petitioner.

The proceeding was referred to an Official Referee of the Supreme Court of New York who submitted a Memorandum on February 6, 1942. After reciting facts relevant to the third cause of action, the Referee continued as follows:

> I find that the store [the petitioner] is also liable to the bank. It organized the bank and always owned

substantially all its stock. Stockholders' liability and enforcement thereof became impending. Enforcement of such liability in such a large amount would greatly injure the business and the business prospects of the store. Mr. Adam owned the controlling voting stock of the store corporation. He consented to become the record owner of the store's 1700 shares of Bank stock, property then of little if any value and to take the bitter medicine which was about to be prescribed for the store. Of course, while Mr. Adam became of record a stockholder of the bank (Sec. 113-a, par. 2, Banking Law) and liable as such, the store—not only by statute (id. cit.) but in truth and fact was the real owner of the stock and could not escape liability as a stockholder merely by going through the procedure adopted.

Richards v. *Robin*, 178 A. D. 535;
Broderick v. *Aaron*, 264 N. Y. 368.

The store has adequately agreed—at least by implication—to indemnify the Adams Estate and in all fairness it should do so. The store is the principal debtor, the Adam Estate the surety. For all practical purposes, this is equivalent to an action to enforce a stockholder's liability. The store stands here as one having given counter-security to its president and I find the old case of *Vail* v. *Foster*, 4 N. Y. 312 (Comstock) adequate authority for the statement that the instant action lies in favor of this plaintiff directly against the store as well as against the Adam Estate. I should note that the repeal of Article 8, Sec. 7 of our State Constitution does not affect any liability which had accrued in the instant situation (*Broderick* v. *Weinsier*, 278 N. Y. 419).

On April 9, 1942, the Supreme Court of New York entered judgments in accordance with the findings of the Official Referee. The judgment in the third cause of action provided that: (1) the Bank recover from the petitioner the sum of $188,373.58 ($170,000, plus interest);

(2) the Bank recover from the estate of Adam the sum of $189,481.65 ($171,000 plus interest); (3) that any moneys collected on the $188,373.58 judgment against petitioner be credited on the $189,481.65 judgment against Adam's estate. In addition, the Court awarded a judgment for $114, costs of the action, against all defendants, both jointly and severally. The defendants, including the petitioner, appealed from the judgment to the Appellate Division of the Supreme Court of the State of New York.

The petitioner wished to compromise the pending appeal. It was influenced by the fact that additional expenses, such as attorneys' fees and interest, would have to be paid if an appeal was prosecuted, and it also believed that a prompt settlement would overcome the feeling of some of its customers that petitioner had not thoroughly protected the Bank's depositors.

During the pendency of the appeal and before any hearing thereon, counsel for the various defendants entered into negotiations with special counsel for the Bank looking to a plan for the retirement of the certificates of withheld deposits and for the settlement and termination of all pending litigation.

The Superintendent, as representative of the New York State Banking Department, required such a plan to include the payment in cash of a sum equivalent to 25 per cent of the unpaid balances of certificates of withheld deposits. This sum was $195,981.93. A portion of this cash was to be obtained from Adam's estate and from certain individual stockholders of their estates. An additional sum of $18,794.28 was to be obtained from the Bank's undivided profits. The balance in the amount of $137,187.35 was to be paid by the petitioner.

A statutory plan (pursuant to section 609 of the Banking Law of New York), dated December 28, 1942, was finally agreed to and approved by the board of directors of the Bank and the Banking Department of New York State. Section 609, 8 (a) of the Banking Law of New York provides:

> A plan for the retirement of certificates [of withheld deposits] issued or made available by a bank * * * pursuant to the provisions of this section may be promul-

> gated in accordance with this subdivision eight in any case where the value of all the assets of such bank * * * as determined by the superintendent is less than the aggregate of the amounts owing to depositors and other creditors plus the unpaid amount of all such certificates so issued or made available by such bank * * *.

As of December 15, 1942, which date is a few weeks before the Plan was promulgated and approved by the Superintendent, the assets of the Bank totaled $2,016,584.24 and its liabilities, including the certificates of withheld deposits, totaled $2,278,362.91. The certificates of withheld deposits totaled $548,749.40 and its other liabilities, to which the certificates of withheld deposits were subordinate, totaled $1,729,613.51.

On March 10, 1943, the Plan was approved by the Supreme Court of New York and was ordered to become effective upon filing by the Superintendent of the necessary certificate. This certificate was filed on April 19, 1943, and the Plan became effective as of that date.

The provisions of the plan for the retirement of the certificates of withheld deposits were drafted in accordance with section 609 of the Banking Law of New York. Pursuant to subparagraph (i) of section 609, within 10 days after the entering of the Supreme Court's order, the Superintendent issued an order directing the Bank to make good the impairment of its capital, and upon receipt of the order the Bank notified the stockholders that they were assessed $100 per share (the par value) on their stock in the Bank. Also, in accordance with section 609, 8(i), by April 17, 1943, which was 30 days after the notice of assessment, the shares of Bank stock were cancelled and thereupon became null and void for all purposes and the rights of the holders ceased. It was provided, however, in accordance with section 609, 8(i) that each stockholder who paid the full amount of the assessment was to receive in lieu of the stock on account of which the assessment was paid new stock in the amount to which he would be entitled if he held certificates issued by the Bank pursuant to section 609 in an aggregate, unpaid principal and interest amount

equal to the assessment so paid. There was no personal liability for these assessments. None of the assessments was paid in whole or in part.

The events that occurred pursuant to the Plan included the following:

1. Some time after April 17, 1943 and during the taxable year ended January 31, 1944, the petitioner paid $137,187.35 to the Bank and the Bank discharged and satisfied its judgment against the petitioner in the amount of $188,373.58, and its judgment against the petitioner and the estates of Adam and his wife for $114, costs of the action. There was set forth in the Plan the explanation that "the judgment awards the Bank a recovery against the Department Store of $188,373.58, in effect representing the statutory liability, including interest from June 18, 1940, of said Store as the beneficial owner of 1700 shares of stock of the Bank * * *." The Bank used this cash, plus cash received from other sources, to pay $195,981.93 to holders of certificates of withheld deposits.

2. The petitioner surrendered to the Bank certificates of withheld deposits aggregating $2,767.47 which it had acquired by purchase. The certificates were surrendered in further compromise of the $188,373.58 judgment. This left outstanding certificates with principal balances then unpaid aggregating $350,000. The petitioner's basis for the certificates was $2,767.47.

3. In exchange for the certificates with an unpaid balance of $350,000, the Bank issued in the name of the registered holders of the certificates 1,750 shares of its capital stock with a par value of $100 each on the basis of one share of stock for each $200 of unpaid principal. As required by the Plan, the holders of the certificates upon receipt of the shares immediately assigned them to the petitioner in exchange for merchandise certificates on the basis of $2 worth of merchandise for each one dollar of par value of capital stock. Hence, the certificate holders received merchandise certificates on the basis of dollar for dollar of the unpaid amounts of their certificates of withheld deposits aggregating $350,000. As required by the

Plan, these acts were done simultaneously. The Plan was binding on each depositor and he had no option but had to let the Bank stock go over to the petitioner in this manner.

The petitioner transferred 10 shares of the new stock to three named individuals and Adam's estate, each of which held 10 of the old shares and, in addition, the petitioner paid $1,000 to the estate of a deceased shareholder which then held 10 shares of the old stock. Upon the consummation of the Plan, the petitioner held 1,700 shares of the new stock and 50 shares were held by qualifying shareholders. No other shares were issued or outstanding.

4. The petitioner paid the fees of counsel of the Bank for his services in preparing and promulgating the Plan, obtaining its approval, and all other expenses in connection with the Plan.

5. The sum of $5,000 was paid to the Bank by shareholders other than the petitioner in satisfaction and discharge of the judgment based on their shareholders' stock liability notes. Included in this sum was $1,000 paid by Adam's estate on Adam's stock liability note in the sum of $171,000, $1,000 of which related to the 10 shares of stock in the Bank owned by Adam.

6. The Bank surrendered to the petitioner the securities deposited with it in 1931 except those disposed of by the petitioner for $495. It was explained in the Plan that these remaining securities had little or no value except for 51 shares with a par value of $100 each.

7. The Bank surrendered the directors' guarantee notes, then reduced from $190,000 to $115,000, the guarantees of the directors, and the collateral security pledged therefor.

8. The Bank surrendered the agreements of March 5, 1932, and surrendered to Adam's estate the Library and released all interest therein.

9. The sums paid to the Bank were in full compromise and settlement of all litigation (except two provisions in the judgment on the fourth cause of action which are not

material here). All pending appeals of the defendants were withdrawn and dismissed.

10. The stockholders' notes in the sum of $175,000 were held by the Bank until consummation of the Plan, at which time they were cancelled.

11. Upon consummation of the Plan, the "bill of sale" of the Library and the Library itself were returned to the estate of Adam.

Although in 1932 the stock certificates originally acquired by the petitioner were cancelled and new certificates were issued to Adam who then held nominal title, the stock was always carried on the petitioner's books of account as an asset. After the old shares in the Bank were declared valueless and cancelled and new shares were issued in the taxable year 1944, the petitioner retained on its books an asset account entitled "Stock-A.M. & A. State Bank" representing its investment in the Bank. Upon the issuance of the new shares, the petitioner continued to carry the investment in the same amount as previously. However, this sum was increased as the petitioner accepted the merchandise certificates it had issued to the Bank's depositors.

The special counsel who was appointed by the Bank in May, 1940, was appointed upon the insistence of the Superintendent for the purpose of taking steps to realize on the directors' guarantee notes and on the stockholders' notes. The Superintendent approved of the appointment with the express understanding (agreed to by the Bank) that although special counsel was being engaged by the Bank to whom he would look for his fees, he was to be guided by the Superintendent as if the Superintendent were the client and without interference by the Bank.

The special counsel filed the action referred to above in behalf of the Bank and represented the Bank in this action. He also represented the Bank in the negotiations, hearing on, and execution of the Plan. Pursuant to the Plan, the petitioner, after April 17, 1943, and during the taxable year 1944, paid to this individual for his services as special counsel to the Bank $11,000, plus $180.50 for expenses in-

curred. The petitioner paid these fees and expenses in further compromise of the $188,373.58 judgment.

In the action referred to above, the petitioner was represented by a firm of attorneys to whom it paid, after April 17, 1943 and during the taxable year 1944, the sum of $2,850 for legal fees and $4.28 for expenses incurred in connection with the action.

After April 17, 1943 and during the taxable year 1944, petitioner paid $2,500 as legal fees to an individual attorney for services rendered in connection with the action and in connection with the negotiations pertaining to the Plan. Of this sum, $1,250 was for services rendered to petitioner in the acquisition of the new shares of Bank stock under the Plan and the balance of $1,250 was paid for defending the suit brought against petitioner by the Bank.

On or about January 31, 1947, petitioner filed a claim for refund of excess profits tax for the taxable year. Petitioner's excess profits tax liability for the taxable year as shown on its return filed for the taxable year was paid within three years prior to the date of filing its refund claim.

The sum of $137,187.35 paid by the petitioner to the Bank in the taxable year 1944 was paid in compromise of a $170,000 liability arising from the petitioner's statutory liability as a stockholder in the Bank. The $170,000 represents the amount of statutory liability as a shareholder in the Bank which the petitioner would have had to pay either directly or through Adam, its nominee, to the Bank as an assessment in 1933 if Adam had not executed the promissory note in lieu of the assessment.

All events fixing the petitioner's obligation to pay the $137,187.35 to the Bank did not occur until April 19, 1943, the effective date of the Plan. The petitioner's liability accrued at that time during the taxable year 1944 and constituted a loss sustained by the petitioner during that year which was not compensated for by insurance or otherwise.

All events fixing the petitioner's obligation to surrender the certificates of withheld deposits with an unpaid balance of $2,767.47 did not occur until April 19, 1943, the effective

date of the Plan. The petitioner's liability accrued during the taxable year 1944 and constituted a loss in the amount of $2,767.47 sustained by the petitioner during the taxable year which was not compensated for by insurance or otherwise.

During the taxable year 1944, the liabilities of the Bank exceeded its assets by an amount in excess of $175,000 (the book value of the capital stock).

The new stock in the Bank was acquired by the petitioner from the holders of certificates of withheld deposits in consideration of the merchandise certificates, and was not received because of or in consideration of the payment of $137,187.35, the surrender and cancellation of the petitioner's certificates of withheld deposits, or the cancellation of the old shares.

The petitioner's 1,700 shares of bank stock cancelled by the Superintendent pursuant to the New York Banking Law, section 609, subdivision 8, subparagraph (i), became worthless by April 17, 1943 and during the taxable year 1944.

Opinion

ARUNDELL, *Judge:* In our findings, we have set forth in considerable detail the various and involved steps incident to the closing, reopening, and reorganizing of a New York state bank. Petitioner was required to and did pay to the Bank during the taxable year before us $137,187.35, and the deductibility of this item under the taxing statutes is one of the questions posed in this proceeding. The petitioner urges the deduction of the sum as an ordinary and necessary expense or, in the alternative, as an ordinary business loss, and the respondent contends that the sum should be capitalized as an additional cost of the shares petitioner had owned in the Bank.

We think it must now be accepted as settled law that the so-called double liability assessment which is placed by law on the owners of bank stock must be treated as an additional cost of the stock to the stockholder, *First Nat. Bank in Wichita* v. *Commissioner,* 46 F. 2d 283, affirming 16 B.T.A. 1399; *Porter Property Trustees, Ltd.,* 42 B.T.A. 681, affirmed without discussion of this point, 130 F. 2d

276; Regulations 111, section 29.24-2; see also *B. Estes Vaughan*, 17 B.T.A. 620; S.M. 4510, IV-2 C.B. 185. But no formal assessment as such was made and petitioner's chief stockholder, Adam, took title to the Bank shares and assumed any liability that might arise from the Bank's condition, subject only to petitioner's agreement to reimburse Adam should the occasion ever arise. In the posture of this case, we do not think there arose a situation which gave rise to an accrued liability on the part of the petitioner until the rights of the parties were determined as a result of extended litigation and a compromise agreement, all of which occurred during the taxable year. During this taxable year, the entire matter was resolved and a plan worked out to settle all the Bank's problems, together with those of its depositors and stockholders.

The petitioner's shares in the Bank were declared valueless by the Superintendent of the Banking Department of the State of New York and the certificates were cancelled at the time the petitioner's liability to pay the $137,187.35 accrued. Hence, when petitioner paid the sum, which was undoubtedly in the nature of or in lieu of an assessment, it suffered a complete out-of-pocket loss for petitioner's stockholdings in the Bank had then ceased to exist. We think it follows when the sum was paid petitioner suffered a deductible loss.

It is true that had the shares continued to have value and remained in petitioner's ownership, the sum of $137,187.35 would have been added to their cost and should the shares subsequently have become worthless, then their loss would have been a capital loss, limited by section 23(g) of the Internal Revenue Code, but the settlement brought about under the Plan left no ownership in the petitioner of the shares it had theretofore owned and the sum was, in our opinion, deductible as a loss under section 23(f) of the Code. I.T. 3351, 1940-1 C.B. 87; see *George H. Stanton*, 36 B.T.A. 112; *Jamieson Associates, Inc.*, 37 B.T.A. 92, reversed on other points *sub nom, Seaside Improvement Co.* v. *Commissioner*, 105 F. 2d 990, certiorari denied, 308 U.S. 618; *Henry Adamson*, 17 B.T.A. 17; *Marjorie Fleming Lloyd-Smith*, 40 B.T.A. 214, affirmed without discussion of this point, 116 F. 2d 642, certiorari

denied 313 U.S. 588; I.T. 2843, XIV-1 C.B. 77; I.T. 2617, XI-1 C.B. 29; cf. *Champlain Coach Lines* v. *Commissioner*, 138 F. 2d 904; *Messenger Corporation* v. *Smith*, 136 F. 2d 172.

It should be pointed out in passing that section 23(g) provides that if any securities, including shares of stock in a corporation or rights to subscribe for or to receive such shares shall become worthless during the taxable year, the loss resulting therefrom shall be considered as a loss from a sale or exchange of capital assets and such loss shall be allowed only to the extent provided in section 117. As we have heretofore pointed out, the immediate loss with which we are here concerned does not fall in the category of a share of stock or a right to subscribe for such share, but arises from the payment of money incident to a prior ownership of shares of stock.

The conclusion we have reached with reference to the treatment of the $137,187.35 makes unnecessary a consideration of petitioner's argument that the sum paid was deductible as an ordinary and necessary expense.

From what we have already said, it follows that the petitioner's surrender of certificates of withheld deposits gave rise to a further loss in the sum of $2,767.47, deductible under section 23(f), since pursuant to the Plan this surrender was an additional step in compromise of the same judgment or liability for which the $137,187.35 was paid.

A further issue arises with reference to the loss suffered incident to the old shares that petitioner had held in the Bank. Petitioner's cost of those shares is set forth in our findings and is the amount of $205,700. The shares became worthless and were cancelled by order of the Superintendent of the Banking Department of New York State in 1943.

During the taxable year 1944, the liabilities of the Bank were in excess of its assets, plus the $175,000 carried in the Bank's capital stock account. Although this financial condition prevailed for some years prior to the taxable year 1944, it was not until the taxable year 1944 that the shares were cancelled and declared worthless by the Superintendent of the Banking Department. Prior to

that event, the Bank was operating occasionally at a profit, the petitioner remained a stockholder entitled to share in the success of the enterprise, and the stock was not worthless.

The cancellation of the shares of stock was not a mere recapitalization formality such as where old stockholders surrender old stock for new stock without the intervention of a new group of stockholders or the payment of consideration for the new stock. The Plan was designed and carried out in the manner authorized by subdivision 8 of section 609* of the New York Banking Laws, and under its terms the old certificates were cancelled and, as stated in the banking statute, "such stock certificates shall be null and void for all purposes and the rights of the holders thereunder shall cease and determine."

Under the terms of the instant Plan, new shares in the Bank were to be issued to the holders of certificates of withheld deposits who were to become the stockholders of the Bank. It is true that under the terms of the Plan the new shares received by the depositors were to be transferred by them to petitioner in exchange for merchandise certificates issued by petitioner, but this arrangement was a purchase by petitioner on a value basis of these new shares and the acquisition of the new shares in no wise resulted from petitioner's previous ownership of the old shares.

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* Section 609, subdivision 8, of the New York Banking Law, sets forth the steps that must be taken in a plan for the retirement of certificates of withheld deposits. One of the steps set forth in subparagraph (i) of this subdivision is the entering of an "order declaring that such plan shall be effective upon the filing by the superintendent in the office of the county clerk of the certificate required to be filed pursuant to subparagraph (k) * * *." Subparagraph (i) then continues: "Within 10 days after the entering of such order, the superintendent shall issue an Order * * * directing that such bank * * * shall forthwith make good the impairment of its capital. Upon receipt of such order, the directors of the bank * * * shall give notice to each stockholder of such requisition and of the amount of the assessment he must pay, which amount shall be the aggregate par value of his shares. * * * all outstanding stock certificates of the bank * * * shall be cancelled of record not less than 30 days after notice of assessment is given to stockholders as herein provided, and thereupon such stock certificates shall be null and void for all purposes and the rights of the holders thereunder shall cease and determine * * *." Pursuant to this subparagraph, however, the old stockholders are given an opportunity to acquire new shares. If a stockholder pays the full amount of the assessment, he shall receive "new stock in the amount to which he would be entitled if he held certificates issued by such bank * * * pursuant to the provisions of this section in an aggregate unpaid principal and interest amount equal to the assessment so paid."

It is our view that the cancellation and voiding of the old stock during the taxable year 1944 was a positive, definitive event, marking the point at which petitioner's ownership in the Bank was extinguished and the old shares representing that ownership became worthless.

The petitioner seeks to deduct its basis for these old shares as an ordinary loss under section 23(g)(4). Paragraph (2) of that section provides that if securities that are capital assets become worthless, the loss shall be a capital loss. Paragraph (4) provides that for the purposes of paragraph (2), stock in a corporation "affiliated" with the taxpayer is not a capital asset. Paragraph (4) further provides that a corporation is "affiliated" with the taxpayer only if at least 95 per cent of each class of its stock is owned directly by the taxpayer (which must be a domestic corporation) and, in addition, more than 90 per cent of the aggregate of the corporation's gross income for all taxable years must have been from sources other than interest and certain other types of income not relevant here.

The crucial provision here is the requirement that 90 per cent of the income be from sources other than interest since the Bank is the corporation which the petitioner seeks to qualify as an "affiliated" corporation within the meaning of section 23(g)(4).

The petitioner does not deny that more than 90 per cent of the aggregate of the Bank's income was from interest, and concedes on brief that "virtually all of any bank's income is derived from interest." However, the petitioner refers to the legislative history of section 23(g) in an attempt to establish that in enacting that section Congress did not intend to include an operating bank within the exclusionary limitation of paragraph (4).

The meaning of this limitation is clear and plain. It is distinctly expressed in language that is easily understood and contains no ambiguities or incompleteness. Under these circumstances, we have no authority to look to its legislative history to determine its purview. We have no choice but to follow the plain meaning of the provision. *Caminetti* v. *United States*, 242 U.S. 470; 50 Am. Jur. Statutes, section 22. We, therefore, hold that the Bank

is not an "affiliated" corporation of the petitioner within the meaning of section 23(g)(4) and petitioner may not deduct the loss as an ordinary loss under that section.

Finally, we come to the question whether petitioner may deduct or must capitalize the various sums totaling $16,534.78 which it paid in the taxable year 1944 for legal fees and expenses. The liability to pay these sums accrued during the taxable year 1944. We agree with the parties that the treatment of the sought deduction is dependent upon the nature and purpose of the litigation or circumstances under which they were incurred and, further, that legal expenses incurred in the acquisition of property must be capitalized. *S. Cupples Scudder, Executor*, 22 B.T.A. 1294; *Safety Tube Corporation* v. *Commissioner*, 168 F. 2d 787; *Virginia Hansen Vincent*, 18 T.C. 339.

Included in the total sought to be deducted in connection with the litigation is the sum of $2,854.28 which was paid by petitioner to counsel in the defense of the action which resulted in petitioner being required to pay the sum of $137,187.35 which we have already discussed in some detail. We think this amount is deductible either as an ordinary and necessary expense under section 23(a) or as a loss under section 23(f).

Also included in the fees sought to be deducted is one of $2,500, a portion of which was in connection with the setting up of the Plan under which petitioner later acquired new shares in the Bank and a portion of which was paid in defense of the Bank's effort to collect from petitioner the liability resulting from its previous ownership of the old shares. In the absence of a definite allocation by the parties, we have allocated, under the principle of *Cohan* v. *Commissioner*, 39 F. 2d 540, one-half of the fee, or $1,250, as incident to the acquisition of the new shares of stock and the remaining $1,250 to defending the claim against petitioner incident to its ownership of the old shares. It follows that one-half of the fee should be capitalized and the remaining one-half is deductible either as an ordinary and necessary expense or as a loss.

There remains the treatment of the legal expenses in the amount of $11,180.50, which was the sum paid by petitioner to counsel for the Bank. Normally a fee paid by one tax-

payer for services rendered to another taxpayer would not be deductible, but it appears in this case that the sum was paid by petitioner as a part of the over-all settlement between petitioner and the Bank, and while the sum was paid directly to counsel it was, in fact, a payment to the Bank in settlement of the Bank's judgment against petitioner. Therefore, for reasons set forth in our discussion of the first issue, it is deductible as an ordinary loss under section 23(f).

Reviewed by the Court.

Decision will be entered under Rule 50.

TURNER, *J.*, dissenting: In my opinion, the loss to the petitioner of the amount of the assessments on the bank stock owned by it was as much a loss on the stock as was the loss of its original investment and, under the rule laid down by the Supreme Court in *Arrowsmith* v. *Commissioner*, 344 U. S. 6, the loss was a capital loss, deductible as such, and not as an ordinary loss, as this Court holds.

MURDOCK and HILL, *JJ.*, agree with this dissent.

* * * * * * * * * *

APPENDIX E

Decision of the Tax Court

19 T. C. No. 130

THE TAX COURT OF THE UNITED STATES

ADAM, MELDRUM & ANDERSON CO., INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Docket No. 24599

Pursuant to the Opinion of the Court promulgated March 26, 1953, the respondent herein, on June 24, 1953, filed a recomputation for entry of decision, the petitioner's acquiescence in the respondent's recomputation being noted thereon. Wherefore, it is

ORDERED and DECIDED: That there is a deficiency in excess profits tax for the taxable year ended January 31, 1944, in the amount of $62,876.60.

[SEAL] (Signed) C. R. ARUNDELL, *Judge*.

Entered June 26, 1953.

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Tuttle v. *United States*, 101 F. Supp. 532	7
United States v. *Goldenberg*, 168 U.S. 95	10

Statute:

Internal Revenue Code of 1939:	
Sec. 23 (26 U.S.C. 1952 ed., Sec. 23)	2, 7, 9
Sec. 117 (26 U.S.C. 1952 ed., Sec. 117)	6

Miscellaneous:

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Treasury Regulations 111, Sec. 29.24-2	8

In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 426

ADAM, MELDRUM & ANDERSON CO., INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 32-53) are reported at 19 T. C. 1130. The opinion of the Court of Appeals (Pet. 25-29) is reported at 215 F. 2d 163.

JURISDICTION

The judgment of the Court of Appeals was entered on July 29, 1954. (Pet. 30-31.) The petition for a writ of certiorari was filed on October 27,

1954. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. Whether the taxpayer's payments, including legal fees, in compromise of its statutory double liability on its bank stock, constituted additions to the cost basis of its stock deductible as a capital loss under Section 23 (g)(1) and (2) of the Internal Revenue Code of 1939, or whether the payments constituted ordinary business losses under subdivision (f) of that Section.

2. Whether the loss resulting from the worthlessness of the taxpayer's bank stock upon the cancellation thereof was a capital loss under Section 23 (g)(2) of the Internal Revenue Code of 1939 or an ordinary loss, within the exception provided by Section 23 (g)(4)(B).

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable

allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

(g) [As amended by Sec. 123 (a)(1) and (2), Revenue Act of 1942, *supra*, and Sec. 112 (a), Revenue Act of 1943, c. 63, 58 Stat. 21] *Capital Losses.*—

(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) *Securities becoming worthless.*—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) *Definition of securities.*—As used in paragraph (2) of this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

(4) *Stock in affiliated corporation.*—For the purposes of paragraph (2) stock in a corporation affiliated with the taxpayer shall not

be deemed a capital asset. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

(A) at least 95 per centum of each class of its stock is owned directly by the taxpayer; and

(B) more than 90 per centum of the aggregate of its gross incomes for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

(C) the taxpayer is a domestic corporation.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

STATEMENT

The pertinent facts are undisputed; they were summarized by the court below, appropriately for present purposes, substantially as follows (Pet. 26-28):

The taxpayer, a New York corporation, was at all times material engaged in the department store business in Buffalo, New York. Beginning in 1923

it owned and operated a bank situated on the mezzanine floor of its store premises for the mutual convenience and advantage of itself and its customers. In 1930 and 1931, the bank fell into financial difficulties, and two stock assessments, together with a transfer of securities by the taxpayer to it and other pledges by its directors, proved inadequate to support it. On May 29, 1933, the Superintendent of the Banking Department of the State of New York took possession of the bank under Section 606 (1) (c) and (e) of the New York banking laws. On the same day, upon application of the bank, the Superintendent surrendered the assets and authorized it to resume business pursuant to Section 609 of the New York banking law, blocking 40% of its demand deposits and issuing certificates of withheld deposits therefor to the depositors. In lieu of a further assessment on the shareholders on account of their statutory double liability under Section 113-a of the New York banking law, the State Banking Superintendent permitted the bank to accept certain promissory notes and other security.

In 1940 the certificates of withheld deposits had not been paid, and the bank sued the taxpayer on a claim arising out of taxpayer's statutory double liability. Judgment was rendered for the bank in 1942, and an appeal was taken. While the appeal was pending, a plan was approved under Section 609 (8) of the New York banking law whereby the taxpayer paid the bank, in compromise of the pending litigation, the total sum of $137,187.35 and certificates of withheld deposits aggregating $2,767.47

which it had previously acquired by purchase; the taxpayer's bank stock, having become worthless, was cancelled; new stock was issued to the holders of the outstanding certificates of withheld deposits at the rate of $1 par for each $2 of unpaid principal claim; and the new stock, under the agreement, was thereupon immediately assigned by the certificate holders to the taxpayer in exchange for its merchandise certificates worth $2 each for each $1 par value of the new bank stock.

The settlement and consummation of the plan took place during the taxable year ended January 31, 1944. The taxpayer sought to deduct the above-mentioned sums aggregating $139,954.82 which it had paid in settlement of the litigation, and also certain related legal expenses totalling $16,534.78, as ordinary and necessary business expenses, or as business losses, incurred in that year. The Commissioner took the position that since the plan, upon consummation, had left the taxpayer's ownership of the bank unimpaired, the transaction involved in effect no more than a capital reorganization or an additional contribution of capital, and therefore no deductible loss was realized by it, or, alternatively, that the loss, if any, was one solely on the stock, under Section 23 (g) (2) of the Internal Revenue Code of 1939, *supra*, p. 3, and hence limited as to deduction by Section 117 of the Code to the extent offset by capital gains. The Tax Court, three judges dissenting, found for the taxpayer. Upon the Commissioner's petition for review, the Court of Appeals, though holding that the taxpayer had

sustained a loss on its investment upon the cancellation of its bank stock in the taxable year, unanimously reversed, agreeing with the Commissioner that any loss suffered was one on stock and therefore a capital loss.

ARGUMENT

1. Characterized by the taxpayer itself as a "narrow question" (Pet. 6), as to which there is no conflict (Pet. 9), the first and main issue presented by the petition is whether taxpayer's payments compromising its statutory liability on its bank stock were capital losses under Section 23(g)(1) and (2) or ordinary losses under 23(f) of the Internal Revenue Code of 1939, *supra*, p. 3. We think the unanimous decision of the Court of Appeals, holding that the payments constituted capital losses, is clearly correct. But even if the question were more doubtful, the characterization of the payments involved in the particular facts of this case could scarcely warrant further review by this Court.

As the court below pointed out (Pet. 28), and as the Tax Court and taxpayer agreed (Pet. 47-48), it is plain that the payment of a statutory double liability imposed on owners of bank stock is to be treated for income tax purposes as an additional cost of the stock to the stockholders. *First Nat. Bank in Wichita* v. *Commissioner*, 46 F. 2d 283 (C. A. 10); *Porter Property Trustees, Ltd.* v. *Commissioner*, 42 B. T. A. 681, affirmed without discussion of this point, 130 F. 2d 276 (C. A. 9); *Tuttle* v. *United States*, 101 F. Supp. 532, 535 (C. Cls.);

cf. *Interstate Transit Lines* v. *Commissioner,* 130 F. 2d 136, 140-141 (C. A. 8), affirmed, 319 U. S. 590, 593-594; Sec. 29.24-2 of Treasury Regulations 111. Both courts below were also in agreement (Pet. 28, 48) that the taxpayer's payment of the amounts here in question "was undoubtedly in the nature of or in lieu of an assessment" on the stock. Finally, the Court of Appeals concurred (Pet. 28) in the Tax Court's view (Pet. 48) that the taxpayer, having paid these sums in compromise of its statutory double liability after its bank stock had been cancelled (but in the same taxable year), had suffered a total extinction of its original investment in the bank and had had, therefore, a fully realized loss of some kind.

At this point, however, the Court of Appeals rejected the Tax Court's conclusion (Pet. 48-49) that the resulting loss was deductible as an ordinary business loss under Section 23(f) on the ground that the old bank stock had been cancelled and ceased to exist before the liability was paid. Instead, following the rationale of this Court's decision in *Arrowsmith* v. *Commissioner,* 344 U. S. 6, the Court of Appeals correctly found decisive the undisputed and indisputable fact that taxpayer's "payment was made on account of the statutory bank stock liability, which continues until satisfied, whether or not the stock itself be cancelled." (Pet. 28.) Here, as in *Arrowsmith,* it made no difference that the "capital transaction" (344 U. S. at 8) was not fully completed at a single point in time; the important fact was that taxpayer's payment was nothing more

or less than an additional loss on its bank stock. Indeed, the present case is far stronger for this conclusion than *Arrowsmith* in that here the whole of the inseparable events taxpayer seeks to divide for tax purposes occurred in a single taxable year, whereas the payments at issue in *Arrowsmith* occurred at least four years after extinction of the stock interests to which the payments related.[1]

Thus, taxpayer errs in its contention (Pet. 13-15) that the court below has misapplied the *Arrowsmith* decision. There is no question that the payments in issue would have been capital losses had the taxpayer paid its long-subsisting statutory liability before cancellation of the bank stock giving rise to the liability. *Arrowsmith* teaches, as the court below held (Pet. 28), that "the taxpayer's delay in meeting its existing obligation [cannot] change [this] statutory liability into something else."

2. The taxpayer's remaining contention (Pet. 15-17), rejected by both courts below (Pet. 29, 51-52), is that all of its losses on its bank stock, including those discussed above, were in any event ordinary rather than capital losses because they fell within the exception in Section 23(g)(4) of the Internal Revenue Code, *supra*, pp. 3-4, for certain types of losses on stocks of affiliated corporations. Dispositive on this point is the clear and unambiguous limitation in 23(g)(4)(B) that this provision is inapplicable unless the corporation asserted to be

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[1] As both the majority and dissenting opinions make clear, the only real difficulty in *Arrowsmith* stemmed from the fact that separate taxable years were involved.

"affiliated" derives more than 90 percent of its income "from sources other than royalties, rents * * * , dividends, *interest* * * * , annuities, or gains from sales or exchanges of stocks and securities * * *." (Emphasis added.) The taxpayer acknowledges (Pet. 16) that more than 90% of its subsidiary bank's income came from interest, and this necessary concession is fatal. For the effort to show by legislative history that Congress meant something other than what it plainly said is without substance.[2]

As the court below observed (Pet. 29), the legislative history taxpayer invokes (though failing even to quote any portions thought to override the plain statutory language) appears to have stressed the limitations upon, rather than the affirmative extent of, paragraph (4) of Section 23(g) in order to allay the fears of various legislators that *all* operating companies—*e.g.,* insurance companies, financial companies, and real estate operating companies—might be thought to fall within the language of the provision. Nothing in this history warrants the departure taxpayer seeks from the plain meaning of the statute, which compels the conclusion reached by both lower courts. Cf. *Browder* v. *United States,* 312 U. S. 335, 338; *United States* v. *Goldenberg,* 168 U. S. 95, 102-103.

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[2] The taxpayer relies for this argument on S. Rep. No. 648, 76th Cong., 1st Sess., p. 9 (1939-2 Cum. Bull. 524, 530), and 90 Cong. Rec. 121 (erroneously cited in the petition, p. 16, as *6* Cong. Rec. 121).

CONCLUSION

The decision of the court below is clearly correct, follows the pertinent and controlling ruling of this Court, and presents no conflict. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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NOVEMBER, 1954.

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